



September 2011

Dear Investor,

U.S. and global equity prices fell in August, with the S&P 500 losing 5.4% and the MSCI World ex-USA Index losing 8.7%. While the S&P 500 ended well off its worst levels of the month, other markets around the world, such as a number of European markets, weren't so fortunate. For this reason, the MSCI World Index ended the month down much more than the S&P 500.

Although it is cliché to say at this point, August was clearly a "risk off" month. Stocks, commodities and other risk assets declined, while the dollar, gold and Treasuries rallied. There have been a number of swings up and down in risk assets since their August lows, but these swings appear to be part of a temporary consolidation within a larger downtrend. In other words, it appears likely we'll see stocks and other risk assets decline further in the coming months.

The reasons behind the recent market declines have been relatively straightforward, and we have covered many of them in recent client letters. At the top of the list has been the increasingly likely default by Greece, which is roiling European stocks—especially European banks. If Greece defaults on its debt, most of the large banks in Europe will find themselves with a large hole in their balance sheets that will have to be filled, likely to the detriment of current shareholders. For this reason, and others, credit default swaps on European banks are now twice as high as they were during the peak of the credit crisis in the fall of 2008.

A close second on the list of reasons for the recent market decline has been the slowdown in economies around the world. GDP growth here in the U.S. for the first half of the year was recently revised downward, and the most recent employment report estimated that there was zero job growth in August. This slowdown comes at a most inconvenient time, as economic growth should, according to theory, now be picking up steam and reducing the government's budget deficit. However, instead of following the normal post-war cyclical path, the economy is following a normal post-financial-crisis path of slow growth and almost negligible employment gains.

The markets now appear to have begun adjusting to this slow-growth trajectory, and this month we will take a look at the likely path of equity market valuations. Although there is a lot to be negative about at the present time, there are also a number of reasons for optimism on the horizon.

<u>Equity Indexes</u>	<u>August</u>	<u>2011</u>	<u>Market Indexes</u>	<u>August</u>	<u>2011</u>
S&P 500 Index	-5.4%	-1.8%	HFRX Global Hedge Fund Index	-3.5%	-5.6%
MSCI World (ex USA) Index	-8.7%	-7.7%	US Dollar Index	+0.3%	-6.2%
Amex Oil Index	-9.4%	-4.0%	CRB Commodities Index	+0.1%	+2.9%
Gold and Silver Index	+5.9%	-3.8%	Gold (Continuous Contract)	+12.2%	+28.5%

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Last month, the Federal Reserve Bank of San Francisco released a short research paper on how demographics influence stock market valuations: *Boomer Retirement: Headwinds for U.S. Equity Markets?* It nicely summarizes how demographics have correlated with valuation over the past 60 years, and also partially explains the undertow the market is feeling and will continue to feel over the next decade from the retirement of the baby boomer generation.

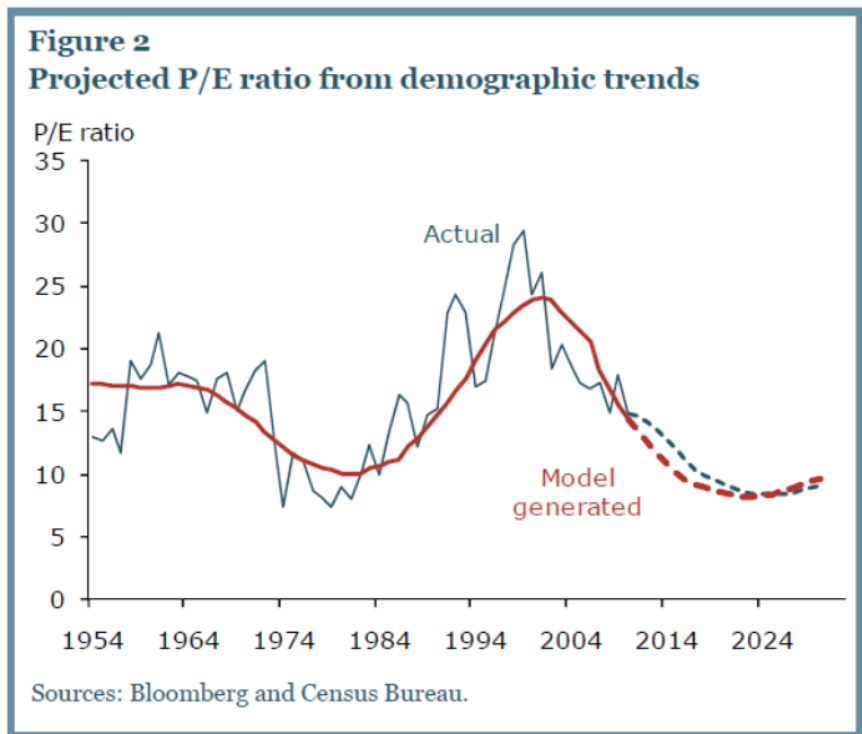
The article can be summarized by the chart below, which shows the actual year-end price-to-earnings ratio of the S&P 500 since 1954 along with a *projected* P/E ratio based on a demographic model. The demographic model used is simply the ratio of the number of people in the U.S. aged 40–49 versus the number of people aged 60–69. This ratio approximates the number of people close to their peak earning years, and hence peak saving years, versus the number of people who are likely transitioning into retirement.

When there are more people saving and putting money into riskier assets like stocks than there are people moving their savings to less risky assets and/or starting to draw down their savings in retirement, stock market valuations tend to move up. This makes intuitive sense, because it is in times like this that more money is flowing into the markets than is flowing out. The opposite is true when there are fewer people saving versus those who are retiring, because it is during those times that less money is flowing into the markets and more money is flowing out.

While there were many economic and business trends that added fuel to the bull market of the 1980s and 1990s, the main force driving valuations was a huge increase in the number of people in their forties relative to the number of people in their sixties. This was the period when most baby boomers entered their peak earning years, and during this time a flood of money poured into stocks and other investments in order to fund retirement plans.

Prior to the rise in the 1980s and 1990s, the number of people in their forties versus the number of people in their sixties fell from the early 1960s through the 1970s. During this time valuations also fell dramatically. Again, although there were a number of other factors that contributed to the decline in valuations during the 1970s, demographics appear to have been a significant factor. In fact, based on the authors' calculations, this demographic trend accounts for 61% of the movement in stock market valuations between 1954 and 2010.

Unfortunately, if this same model is applied to currently available demographic information to see how valuations will likely trend in the coming years, the news is not good. As you can see by the dashed line on the chart, the stock market's valuation is forecast to fall significantly over the next decade. In fact, the authors state that the P/E of the S&P 500 could fall from 15 in 2010 to 8.4 in 2025, a 44% decline.



Studies such as this aren't a forecast of business or economic trends—they are a forecast of the likely *demand* for stock market investments. Like anything in the economy, when the demand for something declines, the price usually follows. Over the last 10 years the ratio of people in their forties to people in their sixties has fallen dramatically, and so have stock market valuations. As this demographic trend is set to continue for another 14 years, it's likely stock market valuations will continue to be pulled lower for some time.

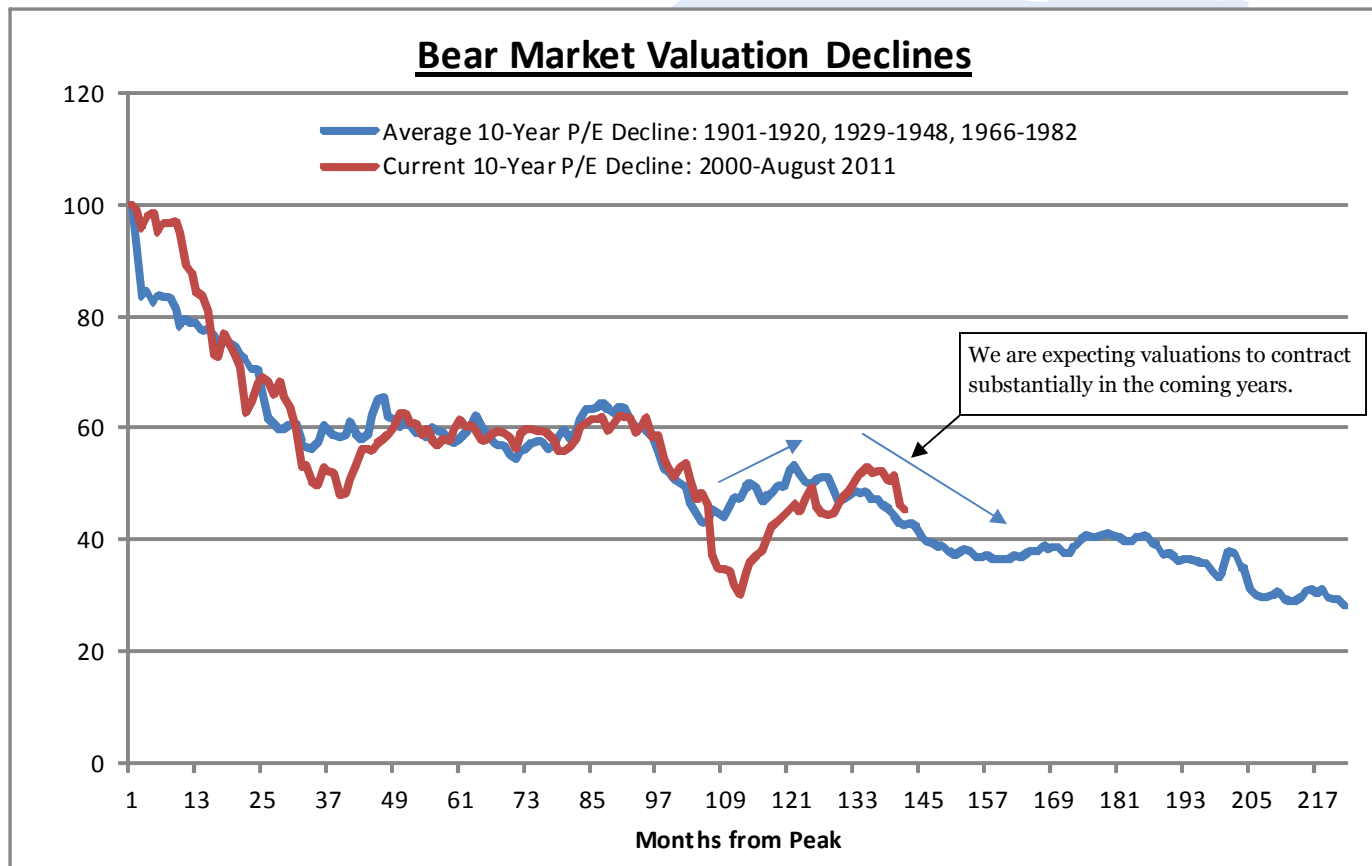
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The study highlighted above takes a look at valuations strictly from a demographic perspective. However, its conclusions fit well with our expectations for valuations over the next decade based on a number of other factors, many of which we have highlighted in client letters over the past couple of years.

In our *2010 Annual Review*, we looked at a chart comparing previous long-term valuation contractions with the current one. The chart below is an updated version with data through August. At the beginning of this year we expected valuations to begin contracting again and start the next leg down in this long-term decline, and it appears that next phase of decline is now underway.

However, it would be a mistake to think that just because valuations appear set to continue their decline, there will be no good opportunities in stocks. While there is every reason to believe stock market valuations will continue to contract for most of the next decade, that does not mean stock *prices* will decline throughout that time.

In fact, stock prices have, in all three previous long-term valuation contractions since 1901 in the U.S., made their nominal price lows well *before* valuations reached bottom. This means that there comes a time in every long-term bear market when the price of the stock market stops going down, even though valuations continue to decline for many years afterwards.



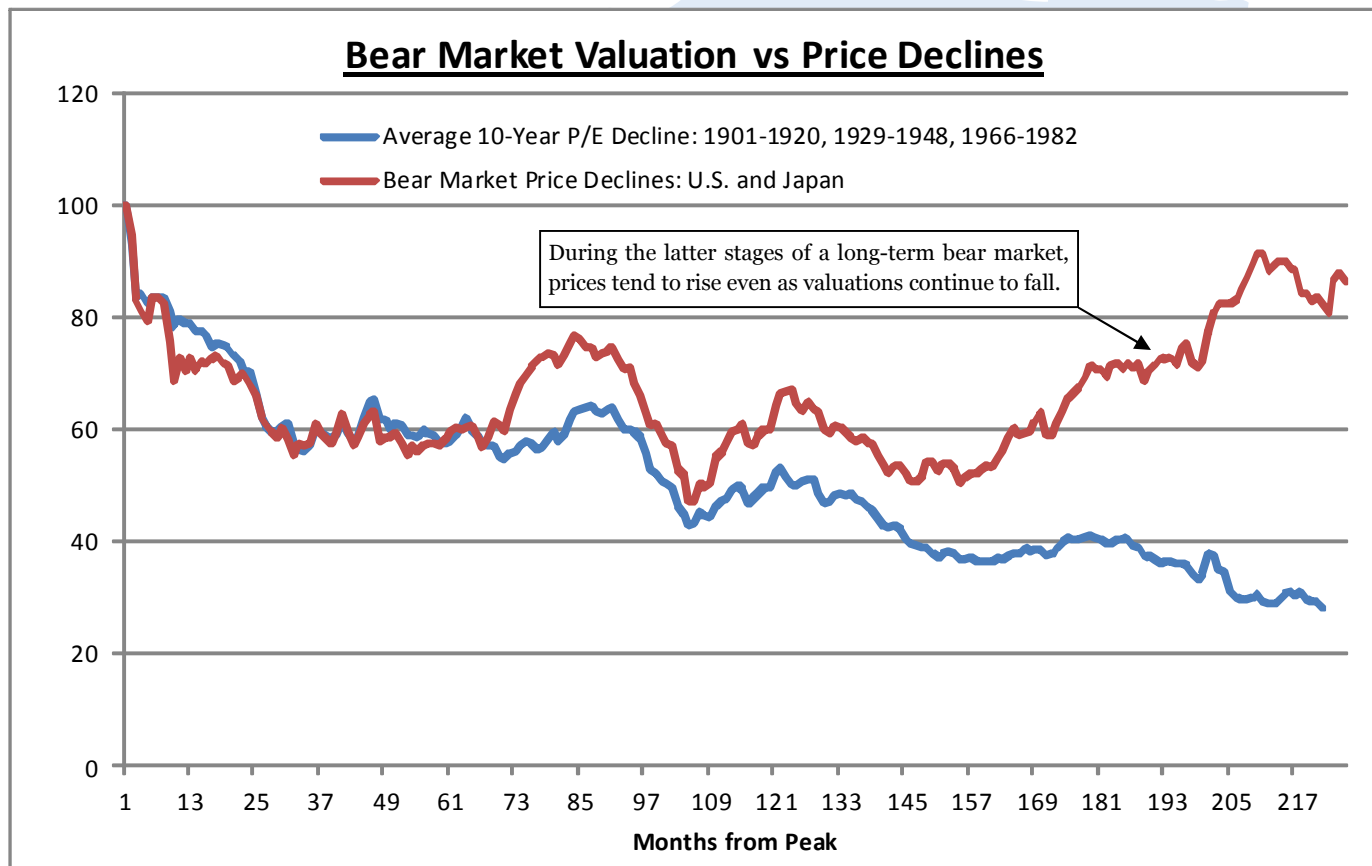
For instance, in the 1929–1948 bear market, the market made its lowest-low in 1932 (3 years after the peak in 1929), and made another significant low in 1942 (13 years after the peak in 1929). By the time valuations began the next long-term trend higher in 1949, the market was more than 60% higher than it was in 1942, and 220% higher than in 1932. In other words, stock prices began rising many years before valuation started expanding again.

During the 1966–1982 bear market, the market made its lowest-low in 1974, 8 years before valuations reached their low. By the time valuations began another long-term trend higher in 1982, the market was 66% higher than its low price point in 1974.

The above low points in price, in 1942 and 1974, occurred 8–12 years into their respective valuation contractions. These price lows were never seen again as stock prices in both periods rallied higher throughout the rest of the bear market. Even though valuations continued to contract and, in the case of the period after the 1974 low, prices failed to keep up with inflation, stocks ended their *nominal* declines and started rising again.

This tendency of stock prices to rise in the later years of a long-term bear market can be seen in the chart below. The blue line is the same as in the previous chart—it shows the average 10-year P/E decline in all three previous long-term bear markets. The red line on the chart shows the average of price of three bear markets, all scaled to the peak of their previous bull markets: the S&P Composite from 1929–1949 and from 1966–1982, and Japan’s Nikkei from 1989–2008. The take-home message is that stock market prices and valuations tend to diverge in the later stages of a bear market—with valuations continuing to fall while prices begin to rise.

Of course, if you know a little about what has happened to Japan over the past 20 years, you probably know that Japan’s Nikkei average today sits near the lows of its long bear market—in direct contrast to “the average” rise of the red line in the chart below. Although stock prices in Japan did in fact rise 100% from



their low in 2003 (13 years into their bear market), the rally did not prove to be durable and prices have since fallen back down.

There have been many comparisons made recently between the current economic situation in the U.S. and what has been going on in Japan for most of the past two decades. There is some merit to these comparisons, especially with regard to how our markets will likely behave as long as consumer credit continues to contract.

However, there are also some very important differences that will, in all likelihood, drive our bear market along a different path than Japan's. Japan's bear market has been a 100% purebred deflationary bear market, complete with an aging and now declining population. The population of Japan has actually declined for the past four years, and the decline is expected to continue in the decades to come.

As we looked at earlier, demographics (and population) play a significant part in determining equity market returns. In contrast to Japan's now declining population, the U.S. population is projected to continue to grow continuously in the coming decades. Estimates vary, but the Census Bureau projects there will be ~30% more people in the U.S. by 2040. This single difference, that of continued population *growth* versus a *decline* in population, will in all likelihood put the U.S. on a very different path than Japan.

When a population is declining, aggregate demand for goods and services declines and aggregate demand for credit steadily erodes. The opposite is true when a population grows. So although the U.S. economy is now going through a moderate deflation fueled in part by demographics (the retirement of the baby boomer generation) and also by a post-bubble de-leveraging, the increases in aggregate demand generated from future population growth will almost certainly steer the U.S. away from a prolonged deflationary trap.

In addition to demographics and population growth, there are a number of other important economic differences that distinguish Japan's decline over the past 20 years from what the U.S. is going through today. So while there is some use in thinking about the similarities, it is important to understand what makes the two situations significantly different.

In the end, U.S. markets will likely travel a very different path than Japan's markets have—probably much more closely to the “average” path outlined in the previous two charts. While valuations will most likely decline over the next 10 years, it's quite possible we could see stock prices start to trend higher once the markets get past the sovereign debt crises in Europe and the housing-related debt deflation in the U.S.

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When we look at how previous long-term bear markets have progressed, the rally in stock prices from the March 2009 low through the high in April of this year occurred at the same time as previous bear market rallies (relative to the peak of the previous bull markets). In the handful of previous cases we have to study, these rallies were not something to commit to for the long run—they were trading opportunities within larger bear markets, which eventually gave way to additional declines. Up to this point, there isn't anything about the rally from the March 2009 low that makes us think that this time is any different.

One of the most difficult things to anticipate in the markets is just how extreme sentiment will get before a trend ends. Market rallies can go on much longer than most investors and traders think possible, and so can declines. Advances and declines can also end earlier than most people expect. Over the past year stock prices climbed higher than we thought they would in response to QEII, but that didn't change the basic nature of the opportunity—or, more precisely, the lack thereof.

However, there appears to be a good possibility that we will be given a more long-term opportunity within the next year or two. The sovereign debt crisis in Europe and the deficit and debt problems here in the U.S. are starting to hit the markets just when history suggests we should expect another significant decline in stock prices that could leave the market in an attractive position, relative to valuations and long-term cycles.

The likelihood of another significant decline is one of the reasons we have tended to be more cautious in our portfolios over the past year and a half. However, it is also reason for guarded optimism, because history suggests stock prices could start to trend higher for good once we get through this next phase in this bear market.

Hedged Growth and Dividend Growth have spent most of the past four years in a hedged or market-neutral position, because since 2007 the market has been in the middle of a strong period of contracting valuations. However, our default stance in these portfolios will change if stock prices are poised to head up in a durable trend higher, supported by attractive valuations and bullish cyclical evidence (e.g., the charts we have discussed in this letter).

Hedged Growth and Dividend Growth both have their greatest potential return when they are fully invested in a strong market, and so we would very much look forward to seeing the type of market environment that enables us to switch to a fully invested stance, by default. For now, however, we remain defensive as it appears another significant contraction has begun.

In Absolute Return, we remain defensive with regard to stocks, but positioned for continued gains in gold and related shares. We still have over 50% of the portfolio in cash, cash equivalents and index hedges, which gives us tremendous flexibility to increase our exposure to stocks, commodities and other risk assets when the outlook brightens.

While gold hit a high just above \$1900/oz in August, the decline since then has been quite shallow relative to previous gains. This strongly suggests this will prove to be another temporary “rest stop” before prices begin another advance. It is certainly possible gold could go through additional short-term declines in the weeks and months ahead, and much of the volatility in Absolute Return and Commodities Focus I is now due to gold’s price swings. However, with the bull market in gold firmly intact, we remain well positioned to benefit from a continued advance.

As always, if you have any questions about your account or issues discussed in this letter, feel free to contact us.

Sincerely,

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